ODDO BHF

MARKET *view*

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Seven key questions about the current climate on the financial markets

> *"Long-term investors can benefit from enduring trends such as digitalisation, artificial intelligence, and advancements in innovative medicine and medical technology, which we expect to play pivotal roles in the upcoming decades."*

The financial markets are going through an exciting phase. Below we provide you with answers to some key questions our clients are asking us.

1. Are US equity markets currently overvalued?

US stocks are indeed highly valued following the price gains of recent years. The price/earnings ratio (P/E ratio) for the S&P 500 is currently at 24.2, which is above its long-term average from 2000 to 2024. When considering the S&P 500 Equal Weight Index, where all 500 stocks are included with equal weight regardless of the companies' market capitalisations, the current P/E ratio drops to 19.8. This discrepancy in valuations is due to the sharp increases in a few large companies, as reflected in the P/E ratio for the "Magnificent Seven" - Amazon, Meta, Alphabet, Tesla, Nvidia, Microsoft, and Apple – which, based on expected earnings for the next 12 months, stands at 35.8. While we do not see a widespread valuation bubble at the moment, some segments of the US stock market are indeed trading at challenging valuations. We seek out quality companies that are trading at a reasonable valuation in the market. Should individual stocks become overly expensive, we'll consider reducing our positions gradually.

2. How can the mood on the financial markets be assessed?

The Fear and Greed Index is a widely used barometer of market sentiment, oscillating between fear and greed to depict investors' mood. It currently stands at 77 on a scale of 0 (extreme fear) to 100 (extreme greed), putting market sentiment at the lower end of "extreme greed". This index incorporates various factors, including market momentum, the magnitude of share price movements, market volatility, the ratio between new 52-week highs and lows on the New York Stock Exchange, as well as the ratio of puts to calls. As it stands, five out of the seven components of the Fear and Greed Index are signalling "extreme greed". As the saying goes, "excess of anything can be detrimental". The current market euphoria serves as a caution against becoming overly bold in our investment decisions.

3. Concentration in long-term comparison

The year 2023 stood out due to the strong emphasis on the "Magnificent Seven" within the US stock market, highlighting investor interest in digitalisation, technology, semiconductors, and artificial intelligence.

Notably, these seven companies boast substantial market capitalisations; for instance, Microsoft's market cap is approximately $3 trillion, while Nvidia's is just under $2.2 trillion. In contrast, Germany's SAP holds a market capitalisation of just over €200 billion. Nevertheless, it's important to examine these seven companies individually, as their valuation metrics can differ significantly. We have chosen not to invest in Tesla, viewing its valuation as excessively high.

However, as long-term investors, we maintain our positions in Alphabet and Microsoft, welcoming the substantial share price increases of recent months.

4. Are US banks at risk?

This month marks the first anniversary of Silicon Valley Bank's collapse, a reminder that US regional banks are sitting on significant unrealised losses, which tallied up to $520 billion as of June 2023, or 26.2% of their combined equity. These losses stem from the devaluation of their bond holdings, triggered by the sharp increase in interest rates since mid-2020. The future of the US banking sector hinges on whether banks can hold onto the bonds until maturity or if they'll be forced to sell them early, realising these losses. With the Federal Reserve likely to lower interest rates this year, additional pressure on the bond portfolios of US banks seems unlikely. Consequently, we don't foresee a systemic crisis in the US banking sector at this moment. Nonetheless, we do not currently invest in US regional bank stocks and are generally avoiding exposure to US banks.

5. How should we react in the event of a recession?

Economic growth in Germany and Europe is weak. The German Council of Economic Experts forecasts a mere 0.3% growth in real GDP for Germany this year, while the IMF projects a 0.5% growth. The IMF also expects modest growth in the eurozone, with a forecast of just 0.9% in 2024. Crucially for stock markets, the economic outlook for the US is more optimistic, with the IMF predicting a 2.1% growth rate this year.

Though not our base-case scenario, a recession in the US remains possible. The global economy outside the US is weakening, with both Europe and China facing challenges. Higher interest rates are pressuring businesses and consumers alike, especially in the real estate sector. Moreover, geopolitical tensions are high. In recent decades, the stock market has always corrected significantly when the economy slipped into a recession.

We do not currently expect the US to slide into recession or that such an event would lead to a stock market crash, primarily due to the strength of the US labour market. However, if our analysis proves incorrect, we would significantly increase our equity allocation. Indeed, it typically makes sense to buy equities counter-cyclically in the last third of a recession, when panic is spreading through the markets and equities are trading at low valuations.

6. When should we expect the ECB's first rate cuts?

The ECB has made significant progress in containing the sharp rise in inflation in 2022/23. According to an initial flash estimate by Eurostat, the rate of inflation in the eurozone rose by just 2.6% in February 2024. However, core inflation, which excludes energy and food prices, remained high at 3.1% in February. We anticipate the ECB may start reducing key interest rates as early as June 2024. For investors, the exact month of the initial rate cut matters less than the overall expectation that interest rates will very likely decrease by 50 to 100 basis points this year. Those investing in the bond market short-term may face lower reinvestment rates in the future. As a result, we have increased the maturity of bonds in our portfolios. A word of advice: short-term investments in fixed-term deposits pose a reinvestment risk. We therefore advise our clients to think about investing their money for the longer term.

7. Investment strategy recommendations: how should investors position themselves?

We are convinced that investors should allocate a substantial portion of their capital to equities for the long term. This is because equities provide a higher risk premium than bonds over extended periods. The term "risk premium" includes the word "risk," implying that long-term equity investments require an investor's readiness to endure short-term market volatility. The longer your investment horizon, the lower your risk of experiencing a loss in the stock market. For instance, anyone who has invested in a diversified stock index like the MSCI World since 1969 has never suffered a nominal loss in any period over 15 years. Long-term investors can benefit from enduring trends such as digitalisation, artificial intelligence, and advancements in innovative medicine and medical technology, which we expect to play pivotal roles in the upcoming decades. For those less inclined to withstand the equity market's high volatility, the recent interest rate increases have rejuvenated the bond market's appeal, especially corporate bonds. Euro-denominated bonds issued by solid investment-grade companies with longer maturities are currently once again offering attractive yields.

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